Barrantagh

Investment Management

CAPITAL MARKETS REVIEW
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- The credit crisis has mutated from issues of illiquidity and valuation in credit markets to the insolvency of large financial institutions precipitating a massive restructuring of the global financial services industry.
- Recapitalization and consolidation of the global financial sector will see control concentrated in fewer hands. More critically the finance industry will shrink as avenues for leveraged growth in structured finance and securitization close.
- The U.S. Federal Reserve has shifted from step by step "stabilization" measures to a comprehensive $700B rescue operation to rid the system of "troubled assets". The Troubled Asset Relief Program or TARP has its limitations but it should help normalize credit markets.
- On the U.S. economic front, a steady stream of negative data recently on consumer spending, jobs creation, and industrial output points toward a rapidly deteriorating outlook. Critically, housing prices continue to decline and mortgage foreclosures are rising. Businesses are also under stress from the credit crunch and from weakening demand. The profit outlook has been revised downward and restricted credit availability threatens capital spending and employment plans.
- Contagion to global economies from U.S. financial and economic woes is mounting. Growth in export oriented Asia, China, India and Japan is slowing and European growth is threatened by the high Euro, collapsing real estate markets and slowing consumer demand.
- Equity markets are experiencing unprecedented day to day swings amidst a weakening overall trend but valuations are compelling. Recognizing that the market is a leading indicator, our strategy is to stay the course and maintain our holdings of leading Canadian and International companies that have the staying power to prosper through the downturn.
- In fixed income markets we remain defensive and invested in shorter duration government bonds until signs of stability in financial markets suggests term extension and some exposure to corporate debt is warranted.

Economic Backdrop – Worsening Economic Fundamentals

The worsening financial crisis has revealed a U.S. and global banking sector that is undercapitalized and over leveraged. An avalanche of landmark transactions has occurred including the bankruptcy of Lehman Brothers, the nationalization of Freddie Mac/Fannie Mae (the multi-trillion dollar linchpin of the U.S. mortgage market) and AIG (the trillion dollar insurance behemoth), the sale of Merrill Lynch to Bank of America as well as a flurry of takeovers and rescue operations in Europe.

The implosion of the largely unregulated "shadow banking system", i.e. the vast network of off-balance-sheet structured finance vehicles was the catalyst for a barrage of claims on bank capital. Lacking the liquidity to respond, the whirlwind of takeovers and rescue efforts ensued. The eventual structure and regulation of the finance industry is in flux but two conclusions are readily apparent. First, trillions of dollars of global finance activity will be concentrated in a few hands. For example, Citigroup, JP Morgan and Bank of America will have in excess of $2 trillion in assets. Secondly, and more ominous perhaps, the industry will be much smaller as large segments of structured finance and derivative markets disappear.

Until early 2008, the response of the U.S. Fed and other regulators was to address illiquidity in the credit markets. However, as credit losses mounted much of the "shadow system", being over levered, became insolvent and that insolvency spread to the banking industry itself. Accordingly, the Fed and the Treasury Department tabled the comprehensive $700B plan to use public money to buy troubled mortgages and other toxic assets (The Troubled Asset Relief Program or TARP). Capital Hill finally approved the plan, but reaction has been guarded. There is a risk that the program will not go far enough and may not succeed in stabilizing the housing market. Furthermore, the crisis has clearly mutated beyond mortgages to other categories of loans including auto leases, credit card debt and working capital loans to businesses.

Meanwhile, the U.S. economy which had held up remarkably through August seems increasingly precarious. Surprisingly, U.S. growth was 2.9% in the second quarter, but foreign trade was the major contributor and is now slowing. Domestically, households contributed only modestly to overall growth in the first half. Consumer spending adjusted for inflation showed a 0.7% drop from April to July and income growth slowed to 2.9% from 4.5% in 2007. The unemployment rate has risen to 6.1%. Although not high by historical standards, (it hit 7.8% after the 1900-91 recession and 10.8% after the 1982 recessions), the trend is worrisome. Job losses have increased by 159,000 in September.

Businesses are also feeling pressure from the credit crisis and from weakening final demand. Factory output has declined (the main Index of factory output plummeted in September to 43.5 from 49.9) and capital spending is being curtailed. In the maelstrom of the financial crisis, the inevitable shrinkage in credit availability will restrict the spending ability of consumers and businesses alike.

At the same time the U.S. credit crunch and economic woes are now permeating global economies. Output is declining in export oriented Japan, Germany, Spain and Britain, and severe stresses are apparent in many other countries. Only China and India are maintaining solid growth. The hope is that the U.S. government's comprehensive rescue plan will stabilize credit markets and provide a first step to an orderly financial system. As banks resume normal lending practices, this essential underpinning of finance to an ailing economy will allow central banks to concentrate on the slowing economies which may help to stave off a serious prolonged recession.

Equity Markets – Compelling Valuations Emerge

In our year-end 2007 investment letter we commented on the fragility of equity markets and forewarned that volatility would be a dominant theme in 2008. We also expressed caution that the credit crisis would involve a protracted workout period. Little did we know at the time that the shock waves emanating from the credit crisis and Wall Street would be so severe and that equity markets would react so violently to unfolding events in the financial systems and economy. The post 1929 world has never experienced a wholesale restructuring of the financial underpinnings to the economy with profound repercussions around the world. Understandably investors have adopted a knee jerk reaction to the flood of banking collapses and the rescue efforts by monetary authorities and surviving banks. For example, on news that the TARP program was being held up in Congress, the S&P 500 plunged 8.8% for its biggest loss since Black Monday in 1987. Canada's S&P/TSX Composite experienced its largest decline in nearly 8 years dropping 7.9%. Both indices regained about half of those losses on the next trading day but violent swings have become all too common over the past month. If you look at peak to trough periods, the markets have witnessed this fear before, albeit for various reasons. For instance, during '73 to '74 (recession), '80 to '82 (recession) and '00 to '01 (technology bubble) the S&P/TSX was off almost 40% each time with long term recovery and excellent markets following the sell off.

Now that the TARP program has been approved investor attention has turned to the state of the economy. Declining oil prices, eroding home values, job security concerns and slowing foreign trade flows are just a part of the picture that can be expected to lead to increased stock market volatility. However, markets tend to lead the economy on both the downside and upside. In fact, global markets have been reacting negatively since the start of 2007, generally anticipating the current credit and economic fall out. It is most likely that the markets will lead the economy on the upside as well. Current market valuations suggest that once the current fear has dissipated markets will react rationally and should improve from a very low base.

Meanwhile, in the short term, businesses face more challenging times in the key areas of profitability and capital spending. Through the first half of 2008, profits were under pressure but they held up well outside of the financial sector. First half earnings for S&P 500 Index companies in fact rose about 7% (excluding finance) but weaker profits in the second half of the year are likely. Until now foreign trade and consumer spending have been key supports to business earnings. With the consumer clearly retrenching and trade slowing, corporations will have difficulty staying on course with previous earnings forecast. As well, credit conditions are tightening and many businesses are already experiencing difficulties in financing working capital.

Viewing the short term suggests there does not appear to be a safe haven. However, looking at the longer term things are much more positive. The portfolios of our clients have held up well year-to-date in part because we had reduced our commodity and economy sensitive holdings well before the recent sell off and in part because the holdings consist of resilient companies with dominant positions in their industries. They have the ability to generate reasonable earnings and free cash flow even in a weak business environment. In light of the recent drying up of various avenues of debt finance to many corporations, large or small, we have reviewed the balance sheets of companies we own and cannot identify any situations where a shortage of capital will put a major crimp in business plans. One of the worst performing areas has been oil and gas which, although a small part of most portfolios, has been a drag on overall performance. At this stage oil and gas producers are trading well below cash takeover bid prices and we will therefore await a recovery in these stocks.

Our overall strategy will be to maintain our core holdings of companies that have demonstrable staying power through the downturn and be vigilant in assessing the timing and the opportunities to position for the eventual recovery. Stability in housing, debt markets and the financial system itself are precursors for a more active stance in our equity approach.

Fixed Income Markets – Flooded Government Bond Market

Fear has overcome greed, and money has consequently poured out of global stock markets and corporate bond markets. Even money market funds have been shunned because of their broad exposure to corporate short term debt instruments. Consequently, the appetite for short term Treasury Bills and government bonds has been virtually insatiable. As government bond prices have risen short term yields have been pushed down below the monetary target levels set by the various central banks.

While the net inflows have been huge, day to day volumes have followed an uneven pattern as bond markets tend to reflect inversely the volatility of the equity market. This has led to unprecedented volatility in the bond markets in recent weeks. In the corporate bond market an ongoing exodus of funds has driven credit spreads steadily wider. The few new issues that have been brought to market, typically for financial services companies, have paid a handsome concession to the market (additional yield over the secondary pricing to incent buyers). While this has allowed successful issuance, the end result has been for credit spreads on outstanding issues from the same issuer or similar issuers to gap wider. In general however, new issue volumes are significantly lower than the market has experienced in years.

The widely watched Canadian TED spread, the spread between the overnight indexed swap (OIS) and the interbank deposit rate (CDOR), has pushed steadily wider to levels not seen since the asset-backed commercial paper crisis first appeared. This key measure of risk indicates a significant flight to quality by investors out of any form of commercial paper or bankers acceptances into government debt, particularly short term paper. Three month Canadian Treasury Bill yields have fallen below 1% on several trading days.

We have also watched the spread between Government of Canada debt and provincial government debt steadily widen, a further indication of uneasiness in the debt markets. Bond markets seem to recognize that the crisis of confidence and subsequent drying up of credit liquidity are issues where traditional monetary tools are not totally effective. However, now that TARP has been approved we do expect central banks to use interest rate reductions in the near future.

All of this turmoil has generated corporate credit spreads that are more in tune with long term averages and more in touch with any risks associated with the corporate bond markets. Finally spreads are reaching a point where the investor will be compensated properly for holding corporate bonds. While we are not yet at a point where we would be willing to add corporate debt to the portfolios, we are watching current developments very carefully. At some point there will be a great opportunity to capture excess return in the corporate bond market, but we will wait for clear evidence of stability and orderliness in credit markets before committing client funds.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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